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Tax Reform Priced In; Not Stronger Economy

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis provides a series of charts to illustrate that the proposed tax reform would be very beneficial to the economy.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Tax reform is priced in, but not a stronger economy**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

Tuesday, December 5, 2017

Tax Reform Is Priced In, But Not A Stronger Economy

The S&P 500 keeps setting new record highs, we are on the cusp of a major tax reform, and the economy is showing signs of perking up. Pessimists fret that we are in another bubble that could pop at any moment, while optimists believe the economy has lots of upside potential.

I am still in the latter camp, although I acknowledge that it is tough to find much that is cheap these days.

In any event, what the market seems to be ignoring is that the kind of tax cuts we are about to experience—which are unprecedented in their focus on businesses—are very likely to lead to a business investment boom, and that, in turn, is likely to result in more jobs, more productivity, and higher wages and salaries in the years to come.

The S&P 500 is up about 24% since the week before Trump won last year's election. Half of that gain is due to increased earnings on continuing operations, while the other half is due to a rise in the multiple the market is willing to pay for a dollar's worth of those earnings (i.e., P/E ratios). Over that same period, 5-year Treasury yields have jumped by about 80 bps (from 1.3% to 2.4%), and real yields on 5-year TIPS have jumped 65 bps (from -0.33% to +0.33%), implying a meaningful increase in real growth expectations but only a modest rise in inflation expectations.

Both the bond and the stock market have thus undergone some significant price adjustments that are consistent with an improved economic outlook. Investors expect more growth (as seen in rising real yields) and rising after-tax profits (as evidenced by higher PE ratios).

So: is the market now pricing in an economic boom because of the likely passage of Trump's tax reform? Or is the market just pricing in the boost to future after-tax earnings that would result from a sizeable reduction in corporate income taxes (from 35% to 20%)?

The way I read the market tea leaves, the market has little doubt that tax reform will pass, and that it will, in turn, boost after-tax corporate profits. But, as yet, I see no convincing evidence that the market is pricing in a substantial increase in economic growth rates—almost certainly not of the magnitude which the Republicans are touting (i.e., 3% or more). So, we are faced with a mixed bag of market expectations: good news for profits and equity investors, but not much reason to cheer for the man on the street. That is missing the forest for the trees.

Outside of the Republican booster community and supply-side economists, I see very few who expect real GDP growth to rise significantly in coming years. Left-leaning commentators argue that the tax reform being pushed is very unlikely to do anything outside of lining the pockets of big business and the wealthy.

A recent Bloomberg article, "Supply-Siders Still Push What Doesn't Work" argues that what is really holding growth back is not high taxes and heavy regulatory burdens, it is an aging population that is still nursing the wounds to confidence it suffered in the Great Recession of 2008-09.

It is not hard to deploy statistics in a way that bolsters your argument, as the Bloomberg article does, but there are some facts in the historical record which should be incontestable: the tax cuts that occurred during the Reagan and Clinton eras boosted economic growth considerably, while the massive fiscal spending "stimulus" of the Obama years failed miserably. (see charts below)

As I argued a year ago, the only good thing about the American Recovery and Reinvestment Act of 2009 was that it served as a laboratory experiment to test the value of the government spending multiplier. ARRA boosters argued that it would kick-start the recovery and deliver strong growth for years to come. Unfortunately, the results were the exact opposite of what was expected by the Keynesians. Why? Because the ARRA was all about income redistribution. It did nothing to change the incentives to work and invest:

> *Fully 63% of the "stimulus" spending was income redistribution in disguise (i.e., tax benefits and entitlements). And if you reclassify things such as education, housing assistance, and health as transfer payments, then over 75% of the $840 billion allocated to "stimulus" was essentially income redistribution. Only 8%—$65.5 billion—went for transportation and infrastructure (i.e., the "shovel-ready" projects that would put America back to work). Not a dime went to increase anyone's incentive to work harder or invest more.*
>
> *The ARRA was a laboratory experiment in the power of the government spending multiplier to grow the economy by "stimulating demand." It ended up proving that the multiplier is way less than one. American taxpayers borrowed $840 billion only to learn that the payoff was only a small fraction of the additional debt incurred. We wasted almost a trillion dollars of the economy's scarce resources, and that is a big reason why the recovery has been so disappointing. If we had instead "spent" the money on lowering tax rates for everyone (e.g., we could have eliminated corporate taxes for three years with the ARRA money spent) in order to give them a greater incentive to work and invest, the results could have been dramatically better. The tax cuts might even have paid for themselves in the form of a stronger recovery over time.*

Income redistribution does nothing to change the long-term growth path of the economy. It takes investment, risk-taking, and working harder and more effectively to boost growth. Incurring debt to finance spending is a waste of the economy's resources, but incurring debt to finance productive investment can lead to a real payoff. Indeed, that was the lesson we learned from the ARRA: excessive spending financed by debt can weaken the economy.

The principle virtue of the Tax Cuts and Jobs Act about to be passed by Congress is that it significantly increases the after-tax rewards to business investment by slashing corporate income tax rates and by allowing immediate expensing of capital investments. This automatically lowers the hurdle rate for all investment projects and, thus, it should lead to a significant increase in investment, jobs, and incomes over time.

The TCJA has its faults, unfortunately, and these center on measures which produce only one-time gains in after-tax income (e.g., increases in the standard deduction and the child credit which do nothing to reward new investment, harder work, or risk-taking). But on balance it is very pro-growth.

The TCJA differs importantly from the Reagan tax cuts in the early 1980s, since the latter focused almost exclusively on lowering individual income tax rates. Reagan gambled that cutting tax rates on individuals would eventually lead to a stronger economy since everyone would have an incentive to work harder and invest more. But by focusing directly on the investment side of the economy, the TCJA could prove even more effective than the Reagan tax cuts.

The charts that follow illustrate the various ways in which the economy is already perking up, and they also illustrate why I think the market has yet to price in a stronger economy as a result of the passage of the TCJA.

Chart #1

<continued>

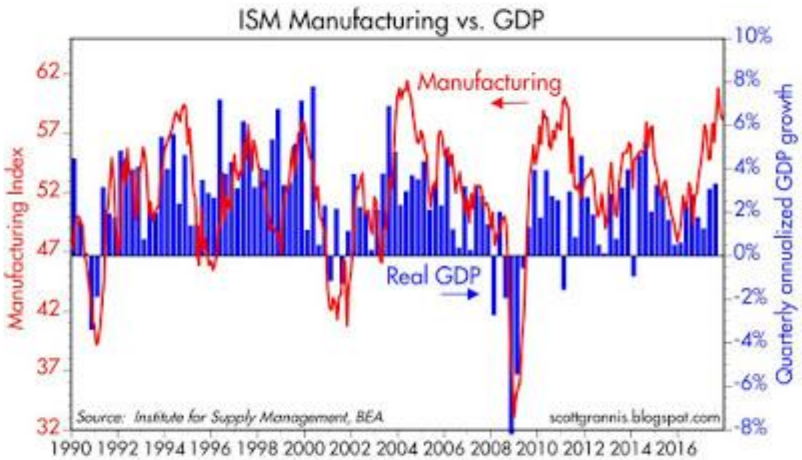
Chart #2

Charts #1 and #2 illustrate the substantial recent upturn in U.S. industrial & manufacturing production, and how that has been accompanied by a significant pickup in Eurozone industrial production. We are seeing a coordinated acceleration in global manufacturing and output, which is a nice tailwind to enjoy.

Chart #3

Chart #3 suggests that housing starts have lots of upside potential, especially considering the strong levels of builder sentiment. By eliminating or limiting the mortgage interest deduction (which subsidizes housing and thus makes housing more expensive than otherwise), the TCJA could make housing more affordable for the middle class and thus stimulate more housing supply. A dramatic increase in the standard deduction would render the loss of the mortgage deduction moot for a whole swath of the population.

Chart #4



As Chart #4 suggests, the ISM manufacturing report is consistent with GDP growth exceeding 3% in the third quarter. The Atlanta Fed's GDPNow index currently predicts fourth quarter real growth of 3.2%. That would put real growth for the year at over 2.7%, which is comfortably above the 2.2% annualized growth rate of the current business cycle expansion. This is very encouraging.

Chart #5

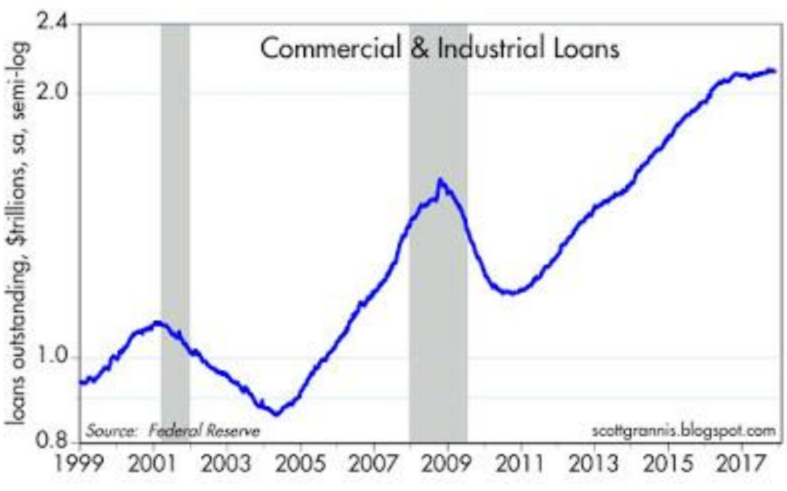


Chart #5 shows a substantial recent slowdown in the growth of Commercial & Industrial Loans (a proxy for bank lending to small and medium-sized businesses). Ordinarily, this would be disturbing since it could be the result of a severe tightening in lending standards. But, …

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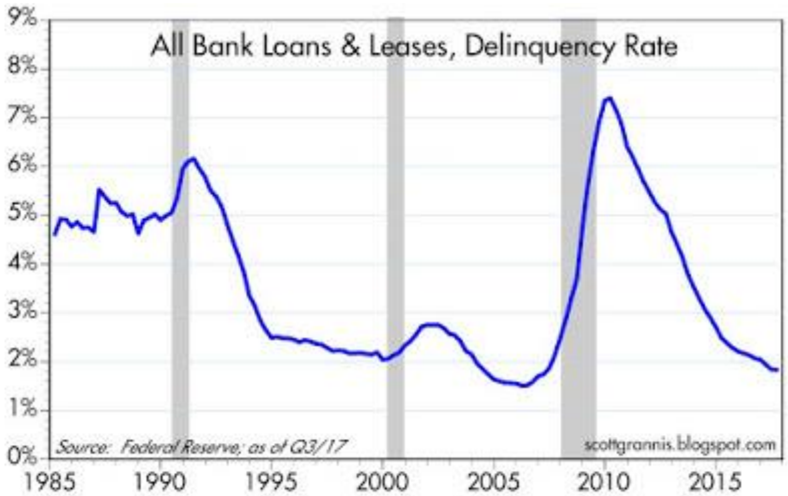
Chart #6



… as Chart #6 shows, banks have little reason to tighten lending standards since delinquency rates on all loans and leases are near record lows. This suggests that the slowdown in lending reflects caution on the part of business borrowers, and that is not necessarily a bad thing. Relative to GDP, C&I Loans are about as high as they have ever been.

Chart #7

Chart #7 illustrates the incredible and lasting strength of corporate profits over the past decade.

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Chart #8

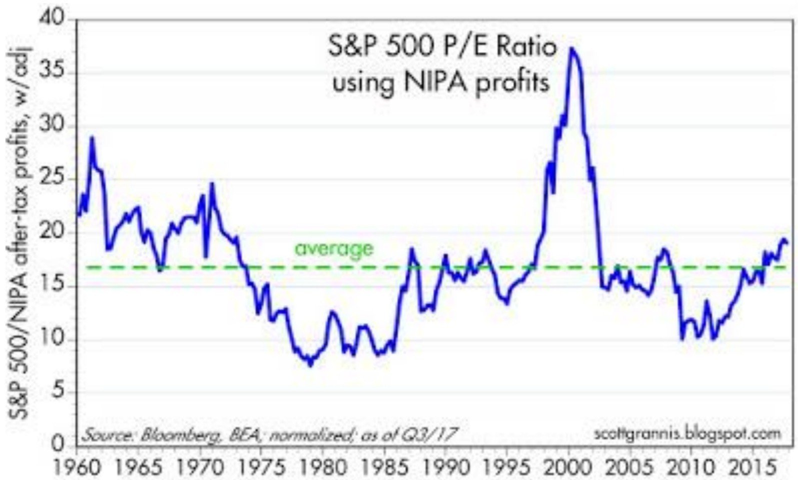


Chart #8 uses this measure of profits (derived from income tax data supplied by businesses to the IRS and compiled into the National Income and Product Accounts) to show that current PE ratios are not excessive by historical standards. Yes, PE ratios are above average, but profits have been way above average for a long time, so the market is not necessarily in bubble territory. I wrote more extensively on this issue [here](#).

Chart #9

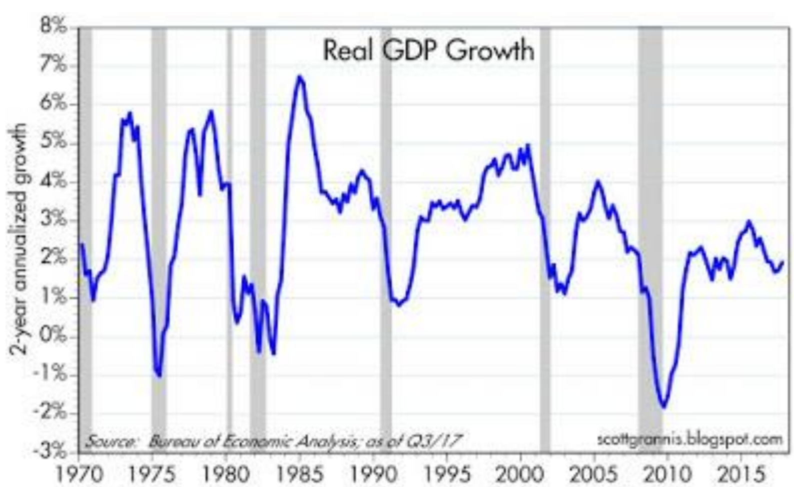


Chart #9 looks at the 2-yr annualized growth rate of GDP since 1970. I use this measure in order to smooth out the typically volatile nature of this series on a quarterly and annual basis. It should be easy to see how strong growth was during the mid- to late-1980s, following the Reagan tax cuts. It also illustrates the impressive strength of the economy in the late 1990s, during which time the capital gains tax rate was cut.

Chart #10

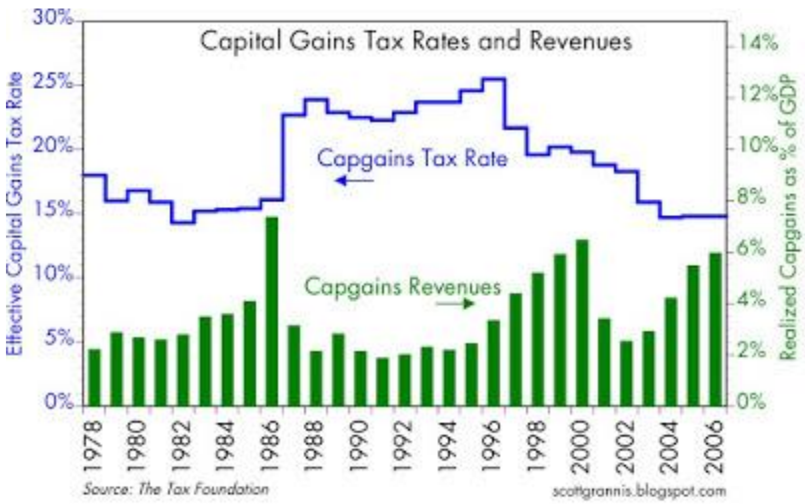
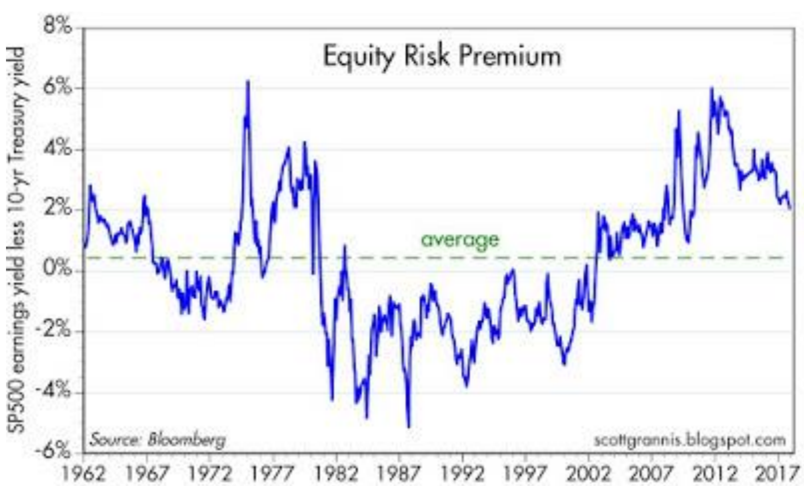


Chart #10 illustrates how sensitive capital gains tax collections are to changes in the capital gains tax rate. Cap-Gains realizations surged in advance of the big hike in the cap-gains rate in late 1986, then dropped considerably, and surged again as the rate was cut during the late 1990s. Lower tax rates can indeed boost tax revenues, while the threat of higher rates can crush tax revenues.

Chart #11



It is noteworthy that the current equity risk premium, illustrated in Chart #11, has remained relatively high in recent years. This suggests investors have been very reluctant to price in a stronger economy. Risk premiums were much lower in the boom years of the 1980s and 1990s.

Chart #12

Chart #12 shows how weak business investment has been in the past decade, despite the extraordinary level of corporate profits shown in Chart #7. A dearth of business investment has been at the root of the economy's sluggish performance over the past decade. That is why the TCJA, which boosts incentives for business investment, could be so important—it directly addresses the problem that has plagued the economy for years. And by lowering business income tax rates here relative to other countries, it could act as a magnet for international capital flows.

Chart #13

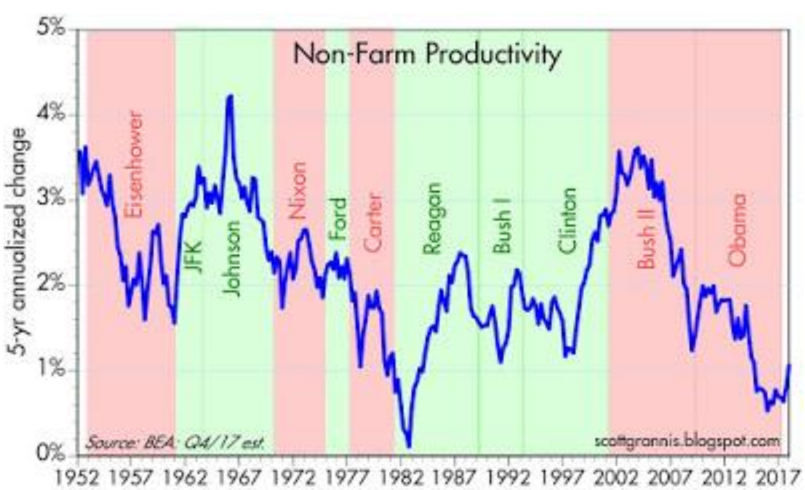


Chart #13 shows the 5-year annualized growth in productivity, highlighted by presidential terms. The Bloomberg article cited above showed the annual growth in output per hour on a year-over-year basis. This measure of productivity is naturally volatile, so measuring it over longer periods makes it easier to see the big trends. Output per hour is not the same as total labor productivity, however, which is shown in Chart #13 and, in any event, changes in productivity are one thing while growth in the overall economy (which includes productivity and the number and hours of people working) is another. Regardless, the very weak growth of GDP and productivity in the Obama years is pretty good proof that the policies pursued during the Obama years were not conducive to growth or prosperity. The second half of the Clinton years, in contrast, rank right up there with the Reagan years, all of which featured tax rate reductions.

Chart #14

Chart #14 shows nominal and real rates on 5-year Treasuries, plus the difference between the two, which is the market's expectation for consumer price inflation over the subsequent five years. Inflation expectations have not changed much in the past few decades, and currently average about 1.8% per year for the foreseeable future, which is very much in line with what inflation has averaged in recent decades.

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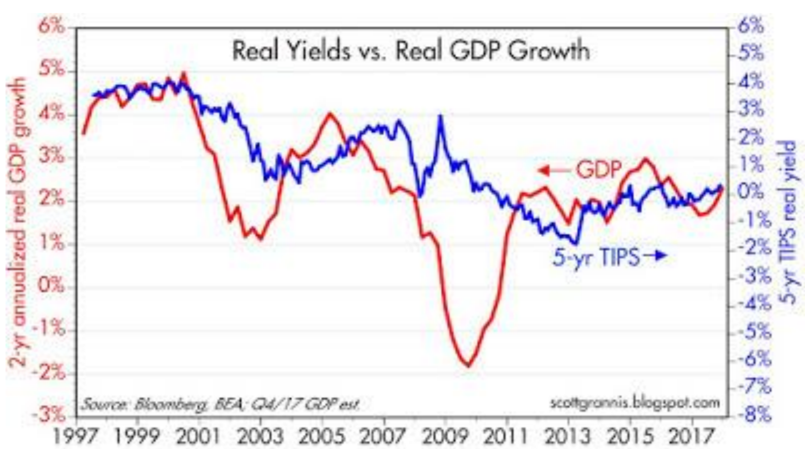
Chart #15

Chart #15 compares the real yield on 5-year TIPS (red line) with the real Fed funds rate (the Fed's target for overnight rates minus the rate of inflation as measured by the PCE Core deflator). Think of the red line as the market's expectation for what the blue line will average over the next 5 years. Note that the real yield curve inverted (i.e., the blue line exceeded the red line) prior to each of the past two recessions. That happens when the Fed becomes so tight that the economy begins to weaken and the market begins to assume that the Fed will be cutting rates in the future. Currently, the real yield curve is still positively sloped. If anything stands out here, it is the market's belief that the Fed is going raise rates only a few more times in the years to come. If the economy picks up steam, however, the Fed is going to be raising rates by a lot more than that.

Chart #16



As Chart #16 shows, the level of real yields on TIPS (blue line) tends to track the economy's real rate of growth over time. That is only logical, since very high real yields can hardly be generated by

a weakly-growing economy, whereas a strongly-growing economy, such as we had in the late 1990s, can produce very positive real yields on a variety of asset classes. The current level of real yields in the bond market is consistent with real economic growth rates that are roughly 2%, which is what we have seen over the recent business cycle expansion. If real growth rates were to ratchet up to 3% or more per year, I would bet lots of money that real yields on TIPS would rise to at least 1-2%. With stable inflation expectations, that would imply 5-year Treasury yields of almost 3-4%, substantially higher than the current 2.2% rate on 5-year Treasuries. Bond investors need to brace for sharply higher yields if I am right about the impact of the TCJA.

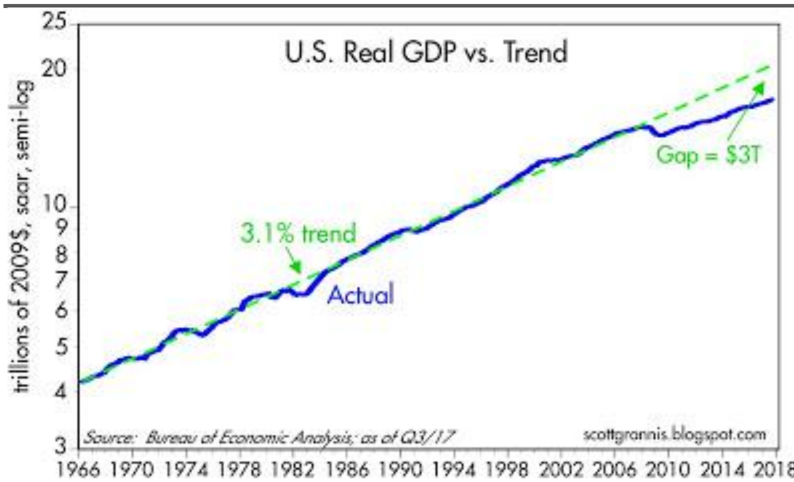
Chart #17

Chart #17 suggests that nominal yields on 5-year Treasuries are unusually low given the current level of core inflation. This reinforces the fact that stronger real economic growth would necessarily lead to substantially higher nominal Treasury yields.

As should be obvious from the last two charts, Treasury yields are quite low compared to where they would probably trade if the economy were to prove much stronger than currently expected as a result of tax reform.

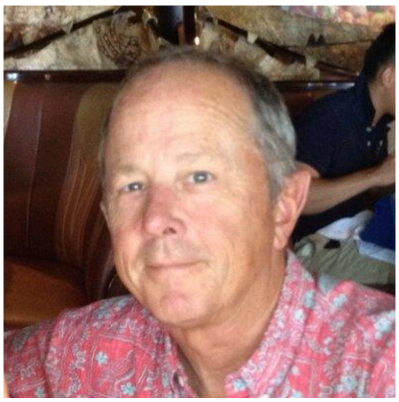
To sum up: the rally in equity prices is evidence that the market is pricing in the passage of tax reform. But the continued low level of real and nominal Treasury yields is evidence that the market has yet to price in the stronger economic growth that is likely to result from tax reform.

UPDATE: I am adding (on the next page) my chart of GDP growth vs its long-term trend in order to give some broader context to this discussion, and to add to some discussion of the subject of "potential" GDP in the comments section.



BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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